in turn, raises the price at which entry is profitable and thereby reduces the financial feasibility of entry. Staggering the contract lengths imposes a permanent cost penalty on entrants, since the potential market available to the entrant will be smaller.

28. *Sabotage* is another tactic that an incumbent BOC could use to raise entry costs. For example, providing poor service in provisioning network elements to a new local carrier raises the expected sunk costs of entry, since the entrant will be forced to increase promotional and marketing expense to offset, if possible, the adverse effects of the BOC's poor performance attributed to it.

29. Strategies that raise customers' *costs of switching from one carrier to another* will also raise entry barriers. Since the incumbent BOC starts with all the local customers, policies that uniformly raise customer costs of switching to another carrier (such as implementing a PIC freeze just as the market opens to entry) protect the incumbent's customer base and raise the sunk costs of entry (since the entrant will have to compensate the customer for the switching costs). BOC policies that differentially raise the costs of entrants (such as revealing the identity of customers who have signed up for PIC freezes only to the BOC's own affiliates, thereby imposing differentially higher marketing costs on other carriers) will raise entry barriers to local service even more.[9]

30. Unbundled network elements are now a panacea to prevent anticompetitive behavior. The FTA places obligations on the incumbent LECs to unbundle their networks. The

[9] PIC freezes give the BOC an advantage in competing for customers who prefer purchasing bundled local and long distance service. The IXCs do not know which customers have signed up for the freezes, so they waste marketing costs reaching those customers. If the BOC's long distance affiliate knows which customers are more expensive to switch (because they have signed up for the freeze), then it utilizes its marketing resources more efficiently.

theory is that such unbundling will reduce an entrant's sunk costs.[10] But the extent to which entry barriers are in fact reduced depends on how well the unbundling works, and it is not in the LECs' interest to assist its direct competitors. If unbundled elements are priced well above economic cost, or if the procedures for purchase of unbundled elements are burdensome or cumbersome, then entry barriers remain prohibitively high.

31. Examples of discrimination by BOCs in the local access market include:

(a) The growth of local competition in Grand Rapids, Michigan was blunted by Ameritech's interconnection tariffs, which were rejected five times by the Michigan Public Utility Commission. The growth of the local entrant, US Signal, fell far short of plan, and its legal fees in the first year of operation far exceeded its revenues.[11]

(b) Bell Atlantic delayed introduction of ISDN capability for PBX trunks until more than a year after it had introduced the ISDN feature for its competing CENTREX service.[12]

(c) Bell South strategically altered the timing of unbundled network features in an effort to favor its own voice messaging service.[13]

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10 The sunk costs of entering local markets can theoretically be reduced, depending on the pricing, by the unbundling required under the FTA. However, unbundling will not ever result in eliminating such costs. There are other sunk costs necessary for entry, such as marketing, that are not covered by the unbundling requirements for network infrastructure.

11 Douglas Bernheim and Robert Willig, *The Scope of Competition in Telecommunications*, AEI Studies in Telecommunications Deregulation, Oct. 1996, at 85-86.

12 *Id.* at 95.

13 *Id.* at 97 (citing *In the Matter of the Commission's Investigation Into Southern Bell Telephone and Telegraph Company's MemoryCall Service*, Order of the Georgia Public Service Commission, Docket No. 4000-U, May 21, 1991). The Georgia Commission found that:

> The record in this case demonstrates at least three significant issues of discriminatory, anticompetitive behavior by SBT in the VMS market regarding access to the local network. In the Commission's view, the evidence on each issue shows at a minimum that SBT has both the opportunity and incentive to use its monopoly control of the local network to defeat competition in the VMS market through its influence on whether, how and when competitors can access the local network. Further, the evidence shows that SBT has not hesitated to take advantage of this opportunity, has used its monopoly control over the local network to gain an anticompetitive advantage in its offering of MemoryCall℠ service and will continue to do so if left unchecked by the Commission.

32. While cost-based prices for UNEs are yet to be established by the Oklahoma Commission, SWBT has revealed its UNE pricing principles in the Statement of Terms and Conditions (SGAT). As Steven Turner's analysis reveals, SWBT has priced UNEs well above economic cost in Oklahoma. Moreover, as SWBT's generally available terms and conditions provide, the procedure for purchasing UNEs is burdensome. SWBT handles the conversion as a disconnect of the current account and a new connect of the UNE account. *See* APPENDIX UNE at § 12.6.1. This appears to be a classic example of the kind of sabotage that can be expected of a monopolist such as SWBT in this situation.

33. SWBT might argue that since entrants will eventually know what rates they will have to pay, they should proceed to invest, and incur now the sunk costs of the facilities they plan to build for themselves. This is incorrect, since whether the investment carries an expected return greater than the cost of capital may depend critically on the prices for the unbundled elements. Uncertainty over the pricing for major inputs can only inhibit entry.[14]

34. Potential competition, including potential competition made possible by the purchase of UNEs from SWBT, will not be as effective as actual competition in constraining SWBT's market power.[15] The literature establishes that when there is almost any measurable degree of sunk costs, market entry can be deterred unless there is a lag between the time of entry and the incumbent's pricing response. This observation provides a rationale for regulatory policies against customer-specific price discrimination. Potential entrants will not incur the sunk costs necessary to enter unless they can expect to recoup those costs, and policies which limit

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[14] *See* Avinash Dixit and Robert Pindyck, *Investment Under Uncertainty*, Princeton University Press (1994).

[15] It is ironic, to say the least, that the BOCs argue that extensive facilities-based competition plus low entry barriers do not provide effective competition in long distance, but an almost complete absence of actual competition, coupled with the assertion that entry will be easy in the future after SWBT unbundles its network, should suffice to remove any concerns about SWBT's ability to exercise market power.

customer-specific price responses by the incumbent help support efficient entry. Thus, an incumbent LEC is sometimes not allowed by regulators to cut prices only to those customers the entrant can serve.[16] Restrictions against customer-specific price cuts by the incumbent are not only fair, but can make efficient entry more viable by providing a lag between entry and the incumbent's narrow price response.[17]

35. Granting SWBT's interLATA application prematurely will adversely affect the development of competition in the local exchange in two ways. *First,* to the extent consumers prefer to purchase bundled local and long distance services, early interLATA entry will give SWBT a strong competitive advantage. If SWBT provides interLATA service before local competition is well established, it will be the only potential source for bundled service for the bulk of the customer base. SWBT could also attempt to erect barriers to local entry via multi-year contracts.

36. *Second,* the long distance industry now features a variety of calling and promotional plans. For businesses, concessions and promotional terms are often individually

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16 The Cable Act of 1992 restricted cable operators from cutting prices only in overbuilt areas. This restriction did help customers in other parts of the cable operator's territory. Ford provides evidence that prices for all the customers were lower in cable systems facing overbuilt competition. *See* George Ford, "Fragmented Duopoly: Evidence on Pricing in the Cable Television Industry," presented at the 1994 Telecommunications Policy Research Conference.

17 Nondiscrimination rules can also help prevent predatory pricing by an incumbent. The standard argument against the rationality of predatory pricing is that cutting prices to all customers imposes substantial losses on the incumbent, so a predatory price cut to all customers is not very likely if the entrant can only serve a few customers. However, if the incumbent knows which few customers an entrant can serve (as, for example, would be the case when the entrant can only serve customers next to its facility) then the incumbent need only cut prices to entrants' likely customers to make entry unprofitable. Cutting prices to all the incumbent's customers would not be necessary.

A policy of limiting localized price reactions by the incumbent loses some of its force if the incumbent's pre-entry price structure entails cross-subsidy. The cream-skimming entry might occur if the incumbent cannot restructure its prices. But even here, the logic against *customer-specific* pricing could be applied. The incumbent could, for example, reduce prices for all customers who contribute to the subsidy, rather than only the subset of those customers to which the entrants can actually provide service.

negotiated (even though the pricing plans themselves are offered on a nationwide basis). Thus, simply by engaging in what is normal business practice in the long distance business, SWBT will be able to offer customer-specific discounts to local service customers most likely to patronize a new entrant. The discounts are pro-competitive in the long distance market, where facilities-based competition is well established. However, such discounts can discourage facilities-based entry for local services, when employed by an incumbent who is just beginning to face competition.

E. SWBT's Incentives to Discriminate Will Increase Once Competition is Established in the Local Market.

37. SWBT's incentives to discriminate (*e.g.* by placing artificial roadblocks to the smooth functioning of the unbundled element market) will increase significantly once competition develops at the retail level. As long as the market share of local competitors is small, SWBT's retail price will continue to be constrained by the regulated maximum price. During this initial period, SWBT benefits from discrimination or cross-subsidy that reduces purchases of UNEs to the extent that: (a) its profit margin at retail exceeds its margin on the sale of unbundled elements, or (b) the higher UNE prices slows the movement of retail customers from SWBT to entrants buying UNEs, in which case SWBT earns higher profits on the UNE sales it continues to make, plus higher profits (because of its higher margin at retail) on any reduction in the amount of UNEs sold.[18]

38. Assuming meaningful competition based on UNE develops, however, there will come a point where SWBT's retail price will no longer remain at the regulated level, but rather

[18] If SWBT can improperly assign costs to the "rate base" for unbundled network elements, the cross-subsidy allows it to receive both benefits a) and b). The FCC's proposed principles for pricing UNEs would not allow such cross-subsidy, because (like pure price caps) it proposed that the price for UNEs be based on engineering cost estimates, and not on the LEC's actual embedded costs or even on the forward-looking costs of that incumbent LEC. SWBT has not followed the policy in Oklahoma, as Steven Turner's statement reveals. This will open the door to cross-subsidy.

will be set by competition. That is, for initial and small losses of retail business to the entrant, SWBT's most profitable strategy will be to maintain its price and accept the loss of business, rather than cut prices more broadly. However, as the amount of retail business which the entrants attract increases, at some point SWBT will find it profitable to cut prices to stem the loss of business.

39. SWBT's retail prices will then be constrained by the CLECs' retail price, which in turn will be based on the regulated price of unbundled elements plus the entrants' costs for the functions they perform themselves. At that point the incentive to restrict the CLECs' purchases of unbundled network elements increases dramatically, since an increase in CLEC costs and corresponding prices now allows SWBT to increase prices to its retail customers as well. Now, SWBT has a third incentive considering actions that would reduce the availability or quantity or raise the price of UNEs, namely, the additional profit on all its retail sales that higher UNE purchases would allow SWBT to charge. It is thus important to recognize that SWBT's incentives to frustrate local entry will be even higher in the future than they are today.

IV. ANALYTIC STANDARDS FOR ASSESSING LOCAL COMPETITION -- HOW MUCH LOCAL COMPETITION IS ENOUGH TO WARRANT ALLOWING SWBT INTO INTERLATA SERVICE?

40. I will first explain why resale and UNE-based competition are only partially effective in providing effective local competition and why significant facilities-based activity by CLECs is necessary before there can be effective competition in local exchange markets. I will then discuss principles for assessing whether facilities-based competition is sufficiently well-established to provide effective local competition.

A. Why Resale is Not Enough

41. Resale is desirable for a number of reasons. In particular, resale inhibits price discrimination and thus reduces the incumbent ILEC's ability fully to exploit its market power at the upstream level (*i.e.*, the wholesale, or UNE, stage). Resale may also facilitate eventual entry into the wholesale stage, by allowing entrants to establish a customer base before investing in their own facilities.[19]

42. However, resale has no immediate effect on the LEC's market power at the upstream level. Resale by itself is thus not an answer to concerns over wholesale market power.[20] Even if SWBT lost all its retail sales to resellers, but faced no competition from facilities-based entry or from competitors relying primarily on unbundled network elements, SWBT would retain its wholesale market power, since it would face absolutely no competition at the wholesale stage.

43. It would be especially inappropriate to view the mere possibility of *future* resale competition as a reason for concluding that SWBT *currently* faces effective local competition. Resale facilitates the development of local competition by allowing a new competitor to assemble an adequate customer base to warrant investing in its own facilities. That is the only way resale contributes to any local competition other than for retailing functions. If the wholesale discount

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19 Resale of AT&T's long distance services during the early years of long distance competition did serve this function. MCI, and later Sprint, were able to serve customers on a nationwide basis before they had nationwide facilities themselves.

20 Resale can help increase price competition at the wholesale stage when there are two or more wholesalers. Because resellers aggregate the demands of smaller customers, they can better negotiate low prices by threatening to take their combined volume of business elsewhere. A threat of this sort will not be credible in local telephone markets any time soon, however, since resellers, in almost all foreseeable circumstances, will have no other facilities-based supplier in which to turn as an alternative source of wholesale capacity.

turns out to be too low to allow resale competitors to gain much share, the process of moving from resale to facilities-based competition could be cut off in its incipiency.

B. Why UNEs Are Not Enough

44. Competition based on UNEs is critical, but it does not eliminate the problem of discrimination once BOCs that control upstream, bottleneck facilities are allowed into long distance. If the only meaningful competition to the incumbent LEC in the downstream local exchange market comes from competitors purchasing UNEs at prices constrained by regulation, then SWBT's prices at retail will remain largely determined by regulation, not by market forces.[21] As long as the prices for UNEs remain constrained by regulation, SWBT retains its incentive to evade regulation. Effective competition in the market for local exchange services would then require effective regulation in the market for upstream elements.

45. This is, however, easier said than done. Today's regulators have limited budgets, and it will be difficult for them to evaluate cost studies and claims of technical infeasibility. Even if we get to the point where customers and regulators agree that, with today's technology, the regulations are working well, one has to start all over again with developing regulatory benchmarks and other transaction criteria as technology changes. Thus, effective competition based on unbundled network elements is reversible. As discussed above, however, once allowed into interLATA long distance service SWBT loses any incentive to cooperate with CLECs in developing reasonable and nondiscriminatory terms for the sale of unbundled elements in the new vintage of technology.

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21 Even if retail prices fall below the maximum retail prices allowed by regulators, competition will only be setting the markup over the regulated price for unbundled network elements.

C. Why Facilities-Based Competition is The Only Fully Effective Means of Regulating the Local Market.

46. The best evidence of irreversible local competition is actual, facilities-based entry that requires significant sunk costs. I previously noted that sunk costs are a deterrent to entry. The flip side of that coin, however, is that when the costs of entry have been sunk, the competition is more likely to be long-lived and effective. Facilities-based entry significantly reduces the potential for non-price discrimination by the incumbent LEC, since the entrant controls its own facilities. In addition, once the entrants have incurred sufficient sunk costs, they are both committed to remain in the market (thus reducing the effectiveness of strategic or even predatory pricing by the incumbent)[22] and also face lower marginal costs, at least in the short run, which allows them to be more competitive in pricing. Thus, significant actual facilities-based competition remains by far the best criterion to use in assessing whether the local exchange bottleneck has been broken. Until it arrives, the market must be controlled by regulation rather than competition. Assuming it does arrive, competition will take over, and the need for regulation will fade. No one could seriously suggest, however, that we are anywhere close to that state of affairs today.

47. In the absence of such facilities-based competition, regulation could be expected to be effective in controlling SWBT's incentives to discriminate only if (a) the transactions were standardized and not subject to significant technical change, and (b) there were natural benchmarks for reasonable performance.

48. Natural benchmarks might be derived from examining similar transactions where SWBT had an incentive to complete the sale, as opposed to frustrate it. For example, it might

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22 For a technical discussion of these issues, *see* Jean Tirole, *The Theory of Industrial Organization*, Chapter 8 (1989).

turn out that the sale of unbundled loops will become a standardized transaction for a product that is expected to experience minimal technical change. If SWBT's performance in provisioning unbundled loop service to customers it loses can be directly compared to its performance to customers it retains or recovers and if the IXC receives service comparable to that received today by a retail customer on new service orders, then natural benchmarks may be available.

49. If product standardization and natural benchmarks are available, regulators could, in principle, impose a reasonable set of performance criteria on SWBT. The assumption of stable technology, if valid, implies that the beneficial effects of the initial regulations are more likely to be irreversible.[23] Even here, however, the regulator would have to detect and punish adoption by SWBT of a contrived change in technology that would not have been adopted but for the fact that it would allow SWBT to force its competitor/customers and regulators to start over in negotiating and regulating new performance criteria for the sale of unbundled elements. Thus, the set of circumstances where regulation can be relied upon to protect the competitive process appears to be rather limited.

D. Potential Competition is Not Effective Competition.

50. SWBT will likely argue that the potential for growth by facilities-based competitors is very high, so that the current *de minimis* shares of existing local competitors does not imply that it will retain market power and the ability to discriminate in the near future. In economics jargon, a market where high market shares does not imply market power because of

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[23] Indeed, enormous welfare gains can be realized by government standard-setting, even where private firms, absent the government-imposed standard, would choose noncompatible, proprietary standards. The terminal equipment market became far more price competitive and exhibited far greater technological change after the FCC imposed standards that sharply reduced the ability of the Bell System to prevent interconnection of non-Bell equipment.

very easy entry is termed a *contestable* market. Because of the high sunk costs of facilities-based entry, or UNE-based entry, the local telecommunications markets are not contestable.[24] It is important to understand why.

51. At the outset, the correct geographic markets are far less than statewide in scope. The "local" in local exchange service is not a misnomer: the arena for effective competition with SWBT is in fact very local. A customer does not yet have an effective competitive alternative unless the competing local carrier can provide retail local exchange service that is: (a) equivalent in price and quality to SWBT's offering, and (b) not dependent on SWBT for any element or service that is essential for providing those final services to that customer on a cost-effective basis. Effective competition thus exists on a customer by customer basis. Just because a customer in city A has meaningful local service alternatives does not imply that another customer in city B halfway across the state has similar alternatives. Nor does it imply that the customer in city A has local service alternatives for local termination of his call to city B. Similarly, just because one customer has a meaningful alternative does not mean that other customers a small distance away in the same city also have meaningful alternatives. For example, the sunk costs of extending service from a fiber ring to a building a few hundred feet away from the ring can be substantial,[25] in which case service via the fiber ring is not a meaningful alternative for customers very close to, but not on, the ring.

52. Consider first the case where the entrants' combined share in one locality is small. For an alternative carrier to be a meaningful alternative to a current customer of SWBT, that

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24 Even economists who often work for the BOCs recognize that "contestibility . . . certainly does not apply to telecommunications." *See* Jerry Hausman and Timothy Tardiff *Antitrust Bulletin* (1995) (both of these authors have prepared draft affidavits on behalf of SWBT in connection with the Oklahoma 271 proceeding).

25 *See* Hatfield Associates, *Enduring Local Bottleneck II*, January 24, 1997.

alternative carrier must face significant customer-specific sunk costs to reach additional customers. If in fact actual local competition is limited to a few niches because the competitors face significant sunk costs to expansion, then a regulated bottleneck monopoly remains and allowing SWBT to enter long distance would entail substantial risks to competition. To allow entry in these circumstances would place an undue reliance in the power of entry and fringe expansion to constrain SWBT from an exercise of market power.

53. Now consider whether effective local competition in city A implies that SWBT will soon face effective competition in other areas. In essence, SWBT would be arguing that effective competition in city A implies that rapid expansion is both feasible and likely in other areas even in the face of SWBT's exercise of market power. In order to reach that conclusion, however, one would have to know either that entrants have sunk or are in the process of sinking the costs necessary to enter the other areas (but do not yet have much market share), or that other markets are similar in all important respects to the city A, so that profitable entry in city A can be expected to be reproduced elsewhere. However, when local entry occurs in a systematic order (*e.g.*, first in high density areas), entry in one area clearly does not imply that similar entry will occur elsewhere. There is solid evidence that the BOCs' recognize that local, facilities-based entry will not be economic in many areas, despite whatever success entrants may have in certain areas where entry is more promising. For example, at page 4 of its 1995 Annual Report, USWest stated:

> *Our region is not an easy one for local-service competitors to enter*. Customers are scattered throughout our 14 states, and our strongest growth is centered outside our top-five metro areas. Many of our fastest-growing cities are in hard-to-serve areas, *where the cost to duplicate our network would be prohibitive.* (Emphasis added.)

54. The presence of facilities-based competition in one part of the state could theoretically provide some protection to customers in other parts of the state where such competition does not yet exist. For example, if state regulation did not allow SWBT to discriminate in its long distance or local service offerings in different parts of the state, then the relevant geographic market is larger than if SWBT is allowed to customize geographically its pricing of long distance services and unbundled network elements or to price discriminate in response to entry. The presence of facilities-based competition for some customers in some areas will only provide SWBT with an incentive to cut prices to customers not facing effective competition if SWBT must cut prices in non-competitive areas in order to retain customers in competitive areas. And, future entry into currently non-competitive areas will only provide SWBT with an incentive to cut prices to those customers today if it knows that it will not be allowed to cut prices to those customers once effective competition for those customers develops. If SWBT is allowed to make customer-specific price reductions in response to competition, only "actual" competition matters. Thus, "potential" competition cannot be relied upon to restrain monopoly power in an industry characterized by significant sunk costs and customer-specific prices and costs.

V. LOCAL COMPETITION IN OKLAHOMA IS NOT WELL-ENOUGH ESTABLISHED TO ALLOW INTERLATA RELIEF.

A. The State of Local Competition

55. It is SWBT's position that the current level of competition in Oklahoma is sufficient to allow it to begin offering interLATA service. Much of the purportedly planned entry into local telephone service is entry by resale, which, as I indicated, does nothing to alleviate SWBT's control of bottleneck facilities. Any additional entry into local exchange markets will be largely through purchase of unbundled elements. I have already indicated that

even competition based on unbundled elements still leaves competitors subject to discrimination, and in particular, to the withholding of necessary cooperation by SWBT. An unknown, but presumably small, amount of future competition based on unbundled elements is a fragile basis for concluding that SWBT currently has no incentive or ability to suppress competition in local exchange markets and to discriminate against competing long distance carriers once it is allowed into long distance. For the prospects of such competition to imply anything about the prospects for actual facilities-based competition, the next step of the argument must be addressed. As a starting point, the Section 271 checklist items must be fully implemented,[26] so that the Oklahoma Corporation Commission and the FCC can examine the terms and conditions (including how well they have actually worked in practice) and address the issue of how quickly a company can justify and make the investments necessary to begin serving (former resale) local service customers with its own facilities. At least at low volumes, there are significant scale economies for local transport and switching. Thus, significant resale-based entry will be necessary before an entrant can justify extensive investment in such facilities.

56. As far as I know, SWBT has been silent on the issue of how quickly facilities-based competition can be expected to develop. However, it is clear that in Oklahoma local competition is virtually nonexistent. Steven Turner's statement presents information on facilities-based competition in Oklahoma. His information shows that local competitors do not yet have a single unbundled loop being used for local service. There simply is no facilities-based competition anywhere in Oklahoma, much less competition across substantial portions of the state for both residential and business customers, as the FTA requires.

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26 That is, full implementation of the check list is a necessary, but not sufficient, condition for interLATA Section 271 authority.

B. Denying InterLATA Relief Will Not Place SWBT at a Competitive Disadvantage.

57. SWBT will not be at a competitive disadvantage if competitors can compete on an integrated basis while it is denied authority to offer interLATA service. Instead, it will be the CLECs who will be at a competitive disadvantage if SWBT is allowed into long distance before meaningful local competition develops.

58. The argument that SWBT will be disadvantaged is based on the assumption that perceived customer preferences for one-stop shopping will give IXCs who integrate into long distance an unfair competitive advantage in competing for local service customers if SWBT is not allowed to also offer both long distance and local service is without merit. One must consider carefully why there may be a customer preference for one-stop shopping. Consider three possibilities:

> (1) The consumer wants "one-bill." The incumbent LECs have the power today to make one-bill service work for their customers. They have generally been able to charge very high prices for billing services (because dead-beat customers will pay a LEC rather than lose telephone service, whereas dead-beats can more easily stiff an IXC who sends out its own bills, since other IXCs may provide service even after the customer is dropped by the first IXC). By pricing their billing services reasonably, BOCs local service offerings can remain billed in conjunction with IXCs, and should not be disadvantaged in local service competition for customers with a preference for receiving only one telecommunications bill.
>
> (2) A preference for one-stop shopping might be based on non-linear price structures that encourage bundled purchases. The major IXCs (any IXC with a nationwide market share greater than 5%) cannot offer cross-product discounts for long distance and local services if their local service is based on resale. Since early entry will be based on resale, IXCs will not be able to offer pricing plans that give a financial inducement to a significant number of customers to engage in one-stop shopping until long after SWBT's requested date of entry into interLATA service. In addition, even if local competition is based on the purchase of unbundled elements from SWBT, the biggest danger is BOC entry before access reform, because then the BOC has a strategic pricing advantage in setting nonlinear prices. Because most early local service entry will be based on

> resale or UNEs, which, according to SWBT, enables SWBT to keep the access profits in Oklahoma, SWBT can offer attractive nonlinear prices (including price plans which bundle long distance and local services) to all its customers, whereas entrants can only do so for customers they serve with their own switching facilities.[27]
>
> (3) Customers might prefer one-stop shopping to avoid "finger-pointing" among multiple suppliers over service, maintenance, *etc*. This is a "Williamsonian" transaction cost argument, and it is based on a failure of third parties (such as courts or regulators) to efficiently resolve contractual disputes. Given contractual failure, the customer desires vertical integration. But the BOCs *can't* have it both ways. They argue that regulation will work very well, and therefore they will not be able to discriminate in service quality, maintenance, *etc*. This presumes that either the courts or regulators will efficiently administer the "contracts" governing the sale of inputs by the BOCs to their local competitors, and to their long distance customers. If these contracts are efficiently enforced, this preference for one-stop shopping is not real, and consumers will soon realize "finger pointing" is not reduced by one-stop shopping. If the advantage is real, then the BOCs' arguments about efficient regulation are incorrect. And it is the competing IXCs and their customers, and not the BOC, who would suffer the competitive disadvantage if BOCs can provide interLATA service before facilities-based local competition is widely established.

59. In fact, it is the BOCs who will have major advantages in competing for customers who prefer to purchase a bundle of services if they are allowed into long distance service before meaningful local competition develops. SWBT will be able to take advantage of a very well functioning wholesale market for long distance capacity to immediately offer a competitive bundle of services to its customers. It will not need the cooperation of any

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[27] Delaying SWBT's entry would give IXCs a pricing advantage only with respect to the small fraction of customers who they will serve with their own switches. Suppose after one additional year of local service competition, 2% of the customers are in SWBT's territory are served by someone else's local switch. If SWBT is allowed to offer in-region interLATA service now, it will have a strategic pricing advantage for 98% of the customers. If SWBT's long distance entry is delayed, its rivals have an advantage for 2% of the customers. In a perfect world, society would not have to accept either inefficiency. However, the FTA requires that the interLATA authority be granted or denied on a state-by-state basis. Given the choice between the two distortions, there are two reasons to delay SWBT's entry. *First*, the distortion associated with delaying their entry is far smaller than the distortion associated with permitting entry now. *Second*, local service is now monopolized, whereas very substantial competition exists in long distance. Thus, encouraging additional local entry is more important to society than allowing additional entry into long distance.

particular IXC to serve such customers. Indeed, SWBT's significant advantage is evidenced by its choice of Sprint as its wholesale supplier of long distance capacity and the 80% wholesale discount Sprint provided to SWBT.[28] In contrast, of course, Sprint will only receive a 19.8% corresponding discount from SWBT, and its ability to offer a bundle of local and long distance services in Oklahoma will, for the near term, be entirely dependent on the nature of the cooperation for both local and long distance services that it receives from SWBT.

60. Once SWBT has been allowed into interLATA long distance, there is good reason to believe that, except for grossly egregious behavior by SWBT, the decision will not be reversed easily. The FCC will not want to tell customers that they can no longer deal with their chosen vendor, even though that customer preference may be based on discrimination or cross-subsidy. Such a decision would also impose switching costs on customers. The reality is that the Commission is likely to view interLATA entry approvals as irreversible, with the removal of authority, once granted, viewed as highly unlikely absent truly egregious behavior. The potential sanction of rescinding interLATA authority will not be effective in policing SWBT.

61. When a decision is irreversible, and there is uncertainty that can be resolved by waiting, then it is optimal to wait for new information so long as the information will resolve some of the uncertainty[29] and the costs of waiting are low. This applies to public as well as private decisions. Here there are two major sources of uncertainty. The first concerns what terms and conditions will apply to competitors' future purchases of unbundled network elements

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28 SWBT will likely parrot the traditional BOC argument generally that a Big Three cartel of AT&T/MCI/Sprint completely controls the long distance market. The ability to find completely adequate long distance capacity independent of the so-called "Big Three" shows that there are additional, major, nationwide players in the interLATA market. This stands in stark contrast to local service, where consumers have no meaningful alternative to SWBT's service.

29 *See* Dixit and Pindyck, *op. cit.*

from SWBT.[30] The second concerns how well the procedures for purchasing unbundled elements actually work in practice, and how much local competition will develop. These issues can only be resolved by waiting and basing judgments on the actual terms and conditions, and the actual procedures as they work in practice.

62. SWBT cannot argue plausibly that there is a significant social cost to waiting. If SWBT argues that it will take a long time to iron out the details for implementing unbundled elements, that implies that entrants will be subject to barriers to local entry.[31] The FCC and state regulators will not impose major penalties on SWBT for these delay tactics if the behavior falls in a gray area. Even where SWBT is told to alter its practices, unless the regulator is convinced that its explanations for delays and problems are entirely without merit, the only likely remedy is forward-looking injunctive relief.[32] This gives SWBT a substantial ability and incentive to delay any efficient local entry that depends on its cooperation.[33]

63. SWBT's economic arguments are likely to contain three basic (and sometimes contradictory) themes. First, the long distance market is asserted to exhibit generally noncompetitive behavior. Second, the asserted failure of competition is especially severe with respect to low volume and residential consumers. Third, SWBT's economists can calculate the economic benefits to Oklahoma that SWBT's interLATA entry would produce.

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30 While SWBT has filed an SGAT in Oklahoma, arbitrations are not complete, and SWBT is claiming the right to revisit the pricing of unbundled elements.

31 SWBT may argue that the IXCs will earn an inefficient competitive advantage if they can enter local service now, whereas SWBT has to wait to enter long distance service. Among the relevant issues is whether the IXCs would gain an inefficient advantage related to one-stop shopping. The short answer is no, and the issue is discussed above in paragraph 59.

32 This is not a mere theoretical prediction. As is reported above, Ameritech's only penalty for its local interconnection tariffs rejected by the Michigan Public Service Commission was to be told to refile.

33 Imagine if the Internal Revenue Service's worst sanction were to tell tax evaders "to go and sin no more."

C. <u>SWBT's Claim of Economic Benefits from InterLATA Relief are Inflated</u>.

64. I will address Wharton Econometrics Forecasting Associates' (WEFA's) predictions of benefits from interLATA entry first. It is important to understand that nothing in WEFA's econometrics addresses whether interLATA entry will reduce prices. The 25% price reduction is an *assumption*. Moreover, WEFA makes the unstated assumption that SWBT entry into in-state interLATA competition will have no negative impact on local competition -- an assumption which is counter-intuitive and highly implausible, in light of the foregoing. If one plugged into the WEFA econometric model the assumption that premature interLATA entry by SWBT would raise long distance prices and retard the development of local competition (relative to what otherwise would have occurred), the model would surely spit out the result that interLATA entry today entails large social costs. Thus, the Commission should largely ignore WEFA's econometrics; the results (at best[34]) are only as useful as the assumptions.

65. Moreover, WEFA's econometricians apparently had no real exchange of information with SWBT's primary witnesses. SWBT's witnesses in draft DOJ affidavits averred that business customers, and especially large business customers, get more competitive rates than small volume customers. Yet WEFA assumed the same percentage price reduction for all customers. This subtle misrepresentation will dramatically affect WEFA's results, since if the only beneficiary of SWBT's entry are low volume customers, the job growth extrapolated by WEFA's computer is nonsense. If the costs to commercial and business customers do not fall, their economics of hiring are almost completely unaffected.

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34 I am not endorsing the WEFA model. In fact, I have no opinion as to whether it is a good or a bad model. My point simply is that even if it is a good model, if you put garbage in, you will get garbage out.

D. The Long Distance Market is Competitive with Regard to Long Distance.

66. With regard to long distance, the increasingly competitive performance of the long distance business stands as one of the major triumphs of modern antitrust policy. Since divestiture, long distance prices per minute have fallen 70% in real terms, even after adjusting for reductions in access charges.[35] We all should be so lucky that local service prices (such as those provided by SWBT) should have exhibited the same pattern. Unfortunately, local service prices have been roughly constant in real terms since divestiture. There can be no doubt that competition has protected the interests of long distance consumers far better than regulation has protected the interests of local customers.

67. In addition to the substantial declines in real prices, other structural aspects of the long distance also show the increasingly competitive constraints on market performance in the past several years. We now have four nationwide networks capable of serving all customers in the U.S. Yet SWBT suggests that local services will be competitive with only one supplier plus the possibility of others. This is nonsense!

68. We have seen a dramatic reduction in AT&T's market share, from over 90% before divestiture to around 55% today. Entry barriers are far lower than the barriers to entry to local service. Long distance is not contestable (nor are most workably competitive markets in the U.S.). But long distance customers have a bona fide choice among several competing end-to-end carriers. For example, Bell South, alone among the BOCs, has signed a contract with either AT&T or MCI for resale of interLATA services. All other BOCs have been able to fully satisfy their *entire end-to-end needs for every customer in the United States* with

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35 Robert E. Hall, *Response to Analyses of Long Distance Competition*, by Professors Jerry Hausman and Paul MacAvoy on Behalf of Bell South (submitted as an attachment to Reply Comments of MCI Corporation, cc Docket 96-91, filed with the FCC May 25, 1996).

contracts with smaller carriers. In contrast, in SWBT's Oklahoma service territories, almost all customers have no local choice -- they can utilize SWBT's local service or go without.

69. There is a very well-established reseller segment in long distance. This implies that even low volume customers are benefitted by the presence of competition. A competitive resale industry means that all price differentials above the wholesale price for transmission or resold services must be cost-based. This, of course, is precisely what the long distance carriers have been saying — that small volume customers whose list prices (based on price caps) have increased were customers on whom, because of customer-specific fixed costs, they lost money.

VI. CONCLUSION

70. The line of business restrictions in the Modified Final Judgment (MFJ) were based on the incentives for the BOCs to enter markets adjacent to their bottleneck local exchange operations in order to evade the constraints regulators were placing on their prices and profits in local exchange services. In my view, the public interest consideration in Section 271 applications still requires substantial, facilities-based competition before the BOCs should be allowed to provide interLATA long distance service. Only at that point will competitors in adjacent markets (long distance) no longer need to rely exclusively for an essential input on a firm with strong, regulation-induced, anticompetitive incentives.

71. But interLATA competition is not the only market that can be adversely affected by a premature grant of interLATA authority. The FTA opens local exchange markets to competition. Premature interLATA authority will give SWBT a greater ability to engage in behavior that can foreclose or delay local competition, such as signing up important customers to long term contracts for bundled services, cutting prices selectively to customers most likely to patronize new entrants, raising customer switching costs, and sabotaging attempts by new local competitors to rely in part on SWBT's facilities as they begin to provide local service.

72. The interLATA markets are quite competitive. The increasing competition there has benefitted consumers far more than regulation has benefitted consumers of local services. Thus, introducing additional competition into local telephony is very important. The BOCs case that long distance is not competitive is based on erroneous analogies and flat-out fabrication. The best example of the latter is the claim by Mr. Taylor on behalf of Bell South that MCI's average price per minute was $0.21 in 1996, when in fact MCI's average price per minute that year was only $0.146. It is easy to discern market power when revenues are overstated by 50%.

73. Exactly what "substantial, facilities-based competition" means could be a matter for debate in future Section 271 applications. The pro-entry view would emphasize a little actual facilities-based entry, with the potential for rapid expansion relying on unbundled network elements purchased from the BOCs. There are two serious problems with this view. *First,* because SWBT's procedures governing the purchase of unbundled elements cannot remotely said to be in place and available for widespread use by local service entrants, it is not possible to reach informed judgments about entry and fringe supply elasticity that rely on unbundled network elements. We should not now presume that local competition can develop rapidly, when actual experience in the near future can provide an empirical basis for making an informed judgment. *Second,* the UNE pricing is based on interim rates. The Oklahoma Commission has not completed its docket for cost-based rates, and other terms and conditions have also been adopted only on an interim basis. If the final terms are less conducive to economic purchase of unbundled network elements than the interim terms, an interLATA application might be approved based on interim arrangements that would have been denied if based on the permanent conditions. Thus, it is clear that no informed decision can now be made about the potential for competition based on unbundled elements in Oklahoma.

74. Finally, the SWBT application is also premature when judged against the "carrot" rationale for interLATA entry. SWBT's incentive to cooperate in making unbundled elements available at cost-based rates derives entirely from the prospect of being allowed to provide interLATA service. Their business incentives are entirely the opposite -- firms generally do not want to reduce the costs others must incur to enter their markets, and SWBT is no different. If SWBT gets its reward (or gets and eats it carrot) before regulators can judge how well the procedures governing competitors' access to unbundled elements actually work in practice, regulators will have no benchmark derived from a time when SWBT had at least some incentive to cooperate against which to judge its subsequent behavior.

VERIFICATION

District of Columbia

~~STATE OF TEXAS~~)
)
~~COUNTY OF~~ ________________)

I, FREDERICK R. WARREN-BOULTON, of lawful age, being first duly sworn, now state: that I am authorized to provide the foregoing statement on behalf of AT&T; that I have read the foregoing statement; and the information contained in the foregoing statement is true and correct to the best of my knowledge and belief.

FREDERICK R. WARREN-BOULTON
Microeconomic Consulting & Research Assoc., Inc.

SUBSCRIBED AND SWORN TO BEFORE ME this 5th day of March, 1997.

Notary Public

My Commission Expires:

My Commission Expires October 31, 1999

EXHIBIT FWB-1

CURRICULUM VITAE